OUTLOOK

A Publication of the South Dakota Retirement System

Number 1 April 2004

2004 Legislature Passes Nine Retirement Bills

New Laws Increase SDRS' Financial Security

Working with the governor and the Legislature during the 2004 session, the SDRS Board of Trustees was able to achieve the passage of its entire package of nine legislative proposals. This package is designed to maintain the system's long-term financial security. Seven of the measures will dramatically reduce SDRS' costs for plan provisions that have, over time, proven more expensive than anticipated. Those provisions range from the purchase of credited service to caps on final average compensation. The passage of these bills further enhances the financial strength of the system, which already is one of the healthiest in the nation.

The Legislature also approved the Special Pay Plan recommended by the board. The plan, coupled with a redefinition of final compensation, will allow Class A members and their employers to save nearly 14 percent of the value of their termination pay by eliminating Social Security taxes and contributions to SDRS. Savings for Class B members and employers, who pay a higher rate of contributions, are even greater.

This issue of *Outlook* explains the new laws and how their enactment may affect an individual member. All laws will take effect July 1, 2004.

2004 Legislation Increases SDRS' Financial Stability

TITLE	RESULT
1 **Final Average Compensation Caps** (HB 1032)	Limits the amount of the lump-sum payment received at retirement that can be used to calculate a member's retirement benefit. Projected reduction in unanticipated costs: $190 million
2 **Special Pay Plan** (HB 1033)	Creates a program that eliminates or defers taxes on termination pay. No fiscal effect on SDRS
3 **Optional Spouse Benefit** (HB 1034)	Increases the cost of purchasing optional spouse coverage by 4 tenths of 1 percent. The increase will allow the program to pay for itself. Projected reduction in unanticipated costs: $15 million
4 **Interest on Accumulated Contributions** (HB 1035)	Changes the minimum and maximum interest rate paid on accumulated contributions withdrawn from the system. Projected SDRS savings: $30 million
5 **Cost to Purchase Credited Service** (HB 1036)	Fully funds the cost to the system of credited service purchases. Projected reduction in unanticipated costs: $30 million
6 **Retire/Rehire** (HB 1037)	Revises benefit payment and membership status of retired members rehired by an employer participating in SDRS, so that members who retire/rehire receive total benefits comparable to those who do not. Projected reduction in unanticipated costs: $20 million
7 **Compensation Basis for Benefit Calculations** (HB 1038)	Changes basis for calculating disability and survivor benefits to be consistent with basis for calculating retirement benefits. Projected reduction in unanticipated costs: $13 million
Eligibility Requirements (HB 1039)	Bases eligibility for vesting and disability benefits exclusively on contributory service. Purchased service will not apply. Projected reduction in unanticipated costs: $5 million
Reporting Funded Status (HB 1040)	Updates requirements for SDRS reports to governor and Legislature and clarifies conditions that trigger action. No fiscal effect on SDRS

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Unanticipated Costs Cut by Millions

Bill Limits Growth in Final Average Compensation

Special payouts for unused sick or annual leave will no longer be used in calculating retirement benefits. Currently these one-time lump-sum payments are added to a retiring member's salary, inflating the

final average compensation and artificially swelling the retirement benefit. Since the increased benefit isn't adequately funded with contributions, the additional costs are borne by all members, including those who don't receive this type of termination pay. After July 1, 2004, SDRS will no longer consider such termination pay to be compensation. As a consequence, no benefits or contributions will be based on it.

The new law will eliminate $190 million in the system's unanticipated costs by reducing the caps on compensation increases close to retirement. It will be applied in a two-step process.

1. On July 1, 2004, the maximum that compensation can increase in the last quarter of employment will drop from the current 125 percent to 115 percent of any prior quarter. The average pay in the last four quarters of employment will be limited to 110 percent of any prior quarter, down from the current 115 percent.
2. On July 1, 2005, both caps will be reduced to 105 percent.

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What You Should KNOW

- If you receive your termination pay before July 1, 2004, it will increase your final compensation, which may increase the amount of your SDRS benefit
- If you receive your termination pay on or after July 1, 2004, your termination pay will not be included in your final compensation.
- On or after July 1, 2004, payments other than termination pay that could increase your final compensation will be capped in a two-step process.

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Frequently Asked QUESTIONS

Q: *Do all SDRS members receive termination pay?*
A: No. For example, some SDRS employers make lump-sum, end-of-career payments for unused sick leave and vacation pay; others do not.

Q: *Will the lower caps reduce my SDRS benefit?*
A: The lower caps will still allow normal pay increases without reducing final average compensation. However, they will limit extraordinary pay increases in the last quarter and last year of your employment.

Q: *I want to work as long as I can but still retire before the new law goes into effect on July 1, 2004. When should I begin the retirement process?*
A: You should contact the SDRS office immediately. To retire under the old law, you must receive your final paycheck before July 1, 2004. Depending on the time of the month you are paid, you may need to retire even before June 1.

Q: *I left employment with an SDRS unit in 2002 but will not retire until 2005. Will the payout I received for unused annual and sick leave be considered in calculating my benefit?*
A: Yes. Because you left employment under the current law, did not have the option of participating in the Special Pay Plan, and made an SDRS contribution on the payout, your final average compensation will include this termination pay.

Legislative Changes Could Save Members Up to 14 Percent

2 Special Pay Plan One Key to Savings on Termination Pay

Legislation that creates a Special Pay Plan, when combined with a redefinition of final compensation, may increase the amount of termination pay that Class A members keep by as much as 14 percent.

The Special Pay Plan will:

- establish an account for the member, funded by the member's termination pay
- exempt termination pay from Social Security taxes (7.65 percent) and SDRS contributions (6 percent for Class A members) when combined with a redefinition of final compensation
- defer federal income taxes until the member withdraws the funds from the Special Pay Plan

2 What You Should KNOW

- The Special Pay Plan is a retirement plan funded by the member's termination pay.
- Termination pay is defined as annual leave, sick leave, contract buyouts, retirement incentives and all other lump-sum payments received when a member terminates employment.
- You must be age 55 or older and receive termination pay of at least $2,000 to qualify for the program. The maximum amount of termination pay eligible for the plan is $41,000.
- Following employers' deposits into Special Pay Plan accounts, members can withdraw funds as soon as is administratively possible.
- Employers may also save 13.65 percent in FICA and SDRS contributions.
- The loss of employer and member FICA contributions is unlikely to significantly affect a member's Social Security benefit.
- The state and Board of Regents are currently the only participating employers in the Special Pay Plan.
- All SDRS employers have the option to participate in the plan.

2 Frequently Asked QUESTIONS

Q: *How much more termination pay will members keep as a result of the creation of the Special Pay Plan and redefinition of final compensation?*

A: Many Class A members may keep 13.65 percent more of their termination pay, saving 7.65 percent in Social Security taxes and 6 percent in SDRS contributions. Based on $10,000 of termination pay, a member would save $1,365. Class B members, who pay a higher contribution rate, may save even more. Further, if members are in a lower tax bracket when they make withdrawals from their Special Pay Plan account than they are when they terminate, they will also owe less in federal income taxes.

Q: *Why isn't the plan available to every SDRS member?*

A: Some SDRS employers may not be able or willing to make the data processing modifications necessary to set up the plan. All employers, however, are eligible to participate.

Q: *Can I leave my termination pay in the Special Pay Plan to supplement my retirement income later?*

A: Yes. The Special Pay Plan will operate similarly to the SDRS Supplemental Retirement Plan. You will have the opportunity to select how you want your account invested and when you want to make withdrawals, subject to legal limits.

For more information about the South Dakota Retirement System, check out the Web: http://www.state.sd.us/sdrs/

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Changes Made in Rates, Compensation Basis

Optional Spouse Coverage to Pay for Itself

Under new legislation, two changes in optional spouse coverage will make the program pay for itself. Contributions will increase by four tenths of 1 percent, to a total of 1.2 percent of a participant's compensation. The law also changes the compensation used in calculating benefits from a member's highest single year's pay to an average of a member's three highest years' pay (a member's final average compensation).

What You Should KNOW

- The increase in contributions will apply to all current and new participants in this voluntary program after June 30, 2004.
- Contributions are not refunded, even if you withdraw from the program.
- The new calculation method will apply to any benefit starting on or after July 1, 2004.
- A member's decision to participate is limited to certain times specified by law; there will be no additional open enrollment periods.

Frequently Asked QUESTIONS

***Q:** Do I need to do anything to continue my enrollment in the Optional Spouse plan after the rate increases?*

A: No. The authorized agent or payroll department in your agency will take care of changes in the payroll deduction for this benefit. You will notice the new amount deducted from any payroll payments made to you after June 30, 2004, regardless of the payroll period the payment covers.

Enrollment periods for Optional Spouse Coverage

Member status	Enrollment period
New SDRS member	Within first year of membership
SDRS member longer than 1 year	Within 90 days of 35th birthday, OR within 90 days of first wedding anniversary

The new law prohibits open enrollment periods waiving these restrictions

4 Changes in Minimum/Maximum Rates

Interest Rates on Contributions to Reflect Economic Conditions

SDRS pays interest on all members' accumulated contributions, based on minimums and maximums set by law. Although the rate of interest does not affect the size of retirement benefits, it does increase the amount of accumulated contributions repaid to members who:

- are not eligible for a vested retirement benefit
- elect to receive a refund instead of a benefit
- die after retirement but have not received benefits exceeding the accumulated contributions they made to SDRS

Currently, the interest rate limitations are:

- a minimum rate of 5 percent per year, which is much higher than current short-term savings rates
- a maximum of 10 percent per year, which is much higher than the system's assumed rate of investment return

To be certain that rates reflect current economic conditions and are consistent with the system's earnings, the new law removes the minimum rate and reduces the maximum rate. As a consequence, the interest on contributions cannot, by law, exceed 90 percent of the interest rate on 91-day US Treasury bills for the preceding calendar year. In addition, that 90 percent cannot be more than the amount the system expects to earn on its own investments, which today is 8 percent annually.

4 What You Should KNOW

- The interest rate paid on contributions has no effect on the size of your retirement benefit.
- The amount of interest added to accumulated contributions is important only when members take a refund instead of a retirement benefit or die after retirement and have not received benefits greater than their member and employer contributions, plus interest.
- Aligning SDRS' interest rates more closely with the market increases the system's financial stability.
- Accumulated contributions that ultimately are refunded to a withdrawing member may grow at a slower rate.

4 Frequently Asked QUESTIONS

Q: *Why doesn't the interest rate on contributions affect the size of my retirement benefit?*

A: Accumulated contributions are not part of the benefit formula. Benefits are calculated using a multiplier, final average compensation and credited service.

Q: *I'm considering leaving public employment and withdrawing my contributions from SDRS. Will I receive a higher interest rate for FY 2004 if I withdraw my accumulated contributions before July 1, 2004?*

A: No. Interest rates are set by the board on a year-by-year basis. The rate for FY 2004 (which ends on June 30, 2004) has been set at 5 percent. You will receive that 5 percent rate even if you terminate after July 1. Beginning on July 1, 2004, however, interest will be calculated at the FY 2005 rate, which the board will set at its April meeting.

5 Purchase Cost Varies with Member's Age

New Rates Will Fully Fund Purchase of Credited Service

Members purchasing credited service will pay its full cost after June 30, 2004. Currently, members buy credited service at 75 percent of the combined member and employer contribution rates in effect at the time the service was rendered. Under the new legislation, a year of credited service will cost Class A members between 12 percent and 30 percent of their annual compensation, depending on the member's age.

Purchase Cost to Increase with Member's Age

Member's Age	Current Pay	Cost Before July 1, 2004*	Cost After July 1, 2004
35	$35,000	7.5% of pay, or $2,625	12% of pay, or $4,200
45	$35,000	7.5% of pay, or $2,625	18% of pay, or $6,300
55	$35,000	7.5% of pay, or $2,625	30% of pay, or $10,500

*original service before July 1, 2002

Under the new law, members of different ages earning the same salary will pay different rates to purchase one year's credited service

5 What You Should KNOW

- After June 30, 2004, the cost of purchasing service increases as you grow older.
- Because contributions to SDRS are higher for Class B members than for Class A members, Class B members will pay a minimum of 16 percent and a maximum of 45 percent of their annual compensation to purchase a year of credited service.
- Purchase rates contracted before July 1, 2004, will not change.
- Only credited service paid for or under a purchase contract before July 1, 2004, will count toward meeting the SDRS vesting requirement.

5 Frequently Asked QUESTIONS

Q: *Why do older members pay a higher rate to purchase credited service?*

A: The longer the purchase payment is in the system, the more dollars the system earns from its investment. The purchase payment of an older member is invested for a shorter time and, consequently, earns fewer dollars. To compensate, the cost of the purchase must be higher.

Q: *In January I signed a contract to purchase service in twenty-four monthly installments. Will my contract be affected by the rate increases?*

A: No, the cost of your purchase will not change under the new law. Your monthly payments will remain the same.

Q: *By July 1, 2004, I will have worked for an SDRS participating employer for one year and purchased one year of credited service. How much longer will I have to work to meet the three-year requirement to become vested?*

A: One year. Credited service contracted or paid for before July 1, 2004, will count toward the vesting requirement. Under new legislation, credited service contracted or paid for after this date will no longer qualify for vesting.

Q: If I want to purchase service under the current law, when should I contact SDRS?

A: **Immediately.** If your prior employer must verify service, the process can be time-consuming. Verification must be completed before a contract can be written, and a contract must be written by June 30, 2004, to be governed by the current law. **Due to the anticipated volume of purchases, SDRS cannot guarantee the completion of contracts initiated after June 15, 2004.**

Q: *I want to purchase service with dollars I have in another qualified retirement plan [457 or 403(b)] using a trustee-to-trustee transfer. What happens if I ask my trustee to make the transfer for the purchase at an early date, but the trustee doesn't make the transfer until after June 30, 2004?*

A: Unfortunately, the law would require SDRS to apply the higher purchase rates in effect after July 1, 2004. **Consequently, members intending to purchase service with a trustee-to-trustee transfer should carefully monitor the status of the transfer.**

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Rehired Employees Enroll as New SDRS Members

Retire/Rehire Legislation Reflects Consensus on Long-standing Issues

6 What You Should KNOW

- The current law will apply to members who retire and rehire before July 1, 2004.
- A member must receive a paycheck for re-employment prior to July 1, 2004 to qualify as retired/rehired under the current law.
- Under the new law, a retired/rehired member must become vested again before qualifying for retirement benefits from re-employment.
- Retirement benefits of Class B Public Safety members rehired as Class A members will continue to include the annual COLA.

After careful and thorough discussions, there is now agreement on a way to manage benefits equitably for members who retire and are then rehired by an SDRS employer. This agreement is expressed in new legislation that consists of three key components:

1. **Change in the COLA** — The annual cost-of-living adjustment (COLA) of 3.1 percent will not be paid on a member's retirement benefit while the member is re-employed by an SDRS employer.

2. **New Member Status** — Rehired members will participate in SDRS as new members, which means they must work an additional three years to become vested again.

3. **Add-on Benefit** — When members retire for the second time, the add-on retirement benefit will be based on the period of re-employment only.

6 Frequently Asked QUESTIONS

Q: *I retired and was rehired in February, 2004. How will this new law change my benefit?*

A: The law will have no effect. The current law will continue to apply to any retired/rehired member who receives a paycheck for re-employment before July 1, 2004.

Q: *What are the consequences of "new member status" for retired/rehired members?*

A: These members must work three additional years to become vested and qualify for an add-on retirement benefit from SDRS. Members should also check with their personnel office for other consequences, such as changes in the rate that vacation is accumulated and policies related to sick leave.

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Board Notes

DECEMBER 10 and 11, 2003

Joint meeting with the Retirement Laws Committee

Fiscal Reports

For the period ending June 30, 2003, Jane Roberts, financial officer, presented SDRS' financial statements; Steve Myers, state investment officer, presented SDRS' investment performance report; Koren Holden, actuary with Mellon Associates, presented the actuarial valuation; and John Aesoph, audit manager with KPMG, presented the financial audit.

Legislation

The board considered and took final action on a package of nine measures recommended to the 2004 Legislature.

Budget

Jane Roberts presented the governor's recommended SDRS budget for FY 2005.

Actuarial Assumptions Study

The board approved initiating a study of the system's actuarial assumptions.

Trustee Attendance at Board Meeting

Present: Brian Berglin, Elmer Brinkman, Carol Burch, Tracy Dahl-Webb, Bryan Gortmaker, James Hansen, Royce Hueners, Louise Loban, K.J. McDonald, Dave Merrill, Pam Roberts, Lowell Slyter, Wes Tschetter, Don Zeller, Sandy Zinter, Steve Zinter, Steve Myers – Ex Officio

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Redefines Compensation for Disability, Survivor Benefits

New Law Makes Basis for Calculating Benefits Consistent

Currently, a member's highest one-year pay in the last three years is used to calculate disability and survivor benefits, while a three-year average (final average compensation) is used to figure retirement benefits. A law taking effect July 1, 2004, removes the discrepancy by requiring all three benefits to use the three-year average.

What You Should KNOW

- The formula for the calculation of retirement benefits will remain unchanged.
- On July 1, 2004, the formula for the calculation of disability benefits will change from highest one-year pay in the last three years to final average compensation.
- On July 1, 2004, the formula for the calculation of spouse and family benefits of a member who dies before retirement will change from highest one-year pay in the last three years to final average compensation.
- The change from highest one-year pay to final average compensation will, on average, reduce a benefit by 3 to 4 percent.

Frequently Asked QUESTIONS

Q: *Does this change apply to members who are already receiving a benefit or only those whose effective starting date for benefits is after July 1, 2004?*

A: It applies only to members (or eligible survivors) whose effective starting date for benefits is after July 1, 2004.

Q: *Why aren't survivor benefits for members who die after retirement affected?*

A: Survivor benefits for members who die after retirement equal 60 percent of the deceased member's retirement benefit, which was based on final average compensation.

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